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BEFORE THE ARIZONA CORPORATION COMMISSION

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Chairman

JIM IRVIN

Commissioner

WILLIAM A. MUNDELL
Commissioner

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Commissioner

Arizona Corporation Commission

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JUN 23 2003

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AZ CORP COMMISSION
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IN THE MATTER OF

INTERSECURITIES, INC.
570 Carillon Parkway
St. Petersburg, FL 33716-1202
CRD #16164

GREGORY RUSSELL BROWN and JANE
DOE RUSSELL, husband and wife
16417 South 15th Drive
Phoenix, AZ 85045
CRD #2233684

Respondents.

DOCKET NO. S-03482A-03-0000

**INTERSECURITIES, INC.'S
ANSWER**

JURY TRIAL DEMANDED

Respondent InterSecurities, Inc. ("ISI") hereby submits its Answer to the Notice of Opportunity for Hearing Regarding Proposed Order to Cease and Desist, for Restitution, for Administrative Penalties, of Revocation and/or Suspension, and for other affirmative relief (the "Notice"). ISI responds to the numbered paragraphs of the Notice as follows:

I. JURISDICTION.

1. ISI denies jurisdiction of this matter because the products at issue are not securities and thus are not within the jurisdiction of the Arizona Corporate Commission Securities Division (the "Division").

II. RESPONDENTS.

2. ISI admits that it was at all relevant times a registered securities dealer in Arizona since 1985, CRD 16164. ISI further admits that its home office is located at 570 Carillon

1 Parkway, St. Petersburg, Florida, 33716-1202. Except as so admitted, ISI denies each and every
2 allegation in paragraph 2.

3 3. ISI admits that Brown was a registered representative with it from August 18, 1995
4 through October 19, 2001 for the sole purpose of selling securities. ISI also admits that Brown's
5 CRD number is 2233684. Brown's primary business was operating an insurance agency, Financial
6 Benefits Group, Inc. ("FBG"), through which he sold the pay telephones at issue. This agency was
7 not an office or branch office of ISI. While Brown was associated with ISI he was licensed as an
8 insurance salesman in Arizona. ISI is without sufficient information or knowledge to form a belief
9 as to the truth or falsity of the remaining allegations, therefore, these allegations are denied.

10 4. ISI is without sufficient information or knowledge to form a belief as to the truth or
11 falsity of the allegations in paragraph 4 and therefore they are denied in their entirety.

12 5. ISI is without sufficient information or knowledge to form a belief as to the truth or
13 falsity of the allegations in paragraph 5 and therefore they are denied in their entirety.

14 6. Paragraph 6 contains no allegations and therefore no response to this paragraph is
15 necessary or required.

16 **III. FACTS.¹**

17 7. In or about April of 1999, Brown sought approval from ISI to sell pay telephones
18 offered by ETS Payphones, Inc. ("ETS") and Phoenix Telecom, LLC ("Phoenix") as an outside
19 business activity through his insurance agency, FBG. ETS and Phoenix sold coin-operated
20 telephones in units which included a telephone and an option to self-manage the phone or lease the
21 phone back to the company for management. ISI denies that the pay telephones were securities in
22 any form, including investment contract, note or evidence of indebtedness. Except as so admitted,
23 ISI denies each and every allegation in paragraph 7.

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26 ¹ The Division has included various headings throughout the Notice which contain accusatory
27 statements without any factual basis. While ISI has not dealt with these headings individually, it
denies any allegations or inferences of wrongdoing contained therein.

1 8. As stated above, the pay phones were not securities and purchasers were given the
2 option to self-manage the phones. Brown offered the payphones to individuals through his
3 independent insurance agency, FBG, not through ISI. ISI had no involvement in the sales of these
4 pay telephones. The operation and maintenance of the pay telephones requires no expertise of any
5 kind. Activity with respect to the payphones could have been handled by the individual or one of
6 the numerous servicing companies throughout the country readily available to service the phones.
7 Any purchaser could have chosen to service their own phone, if he or she so desired. As to the
8 remaining allegations in paragraph 8, ISI is without sufficient information or knowledge to form a
9 belief as to their truth or falsity and therefore they are denied in their entirety.

10 9. ISI admits that Brown acted as a sales agent for Phoenix, ETS and Alpha Telcom,
11 Inc. ("Alpha"). ISI further acknowledges that these companies offered purchasers the option to
12 have their pay telephones managed and/or leased-back by the company. It was fully disclosed to
13 each purchaser that Brown was acting on behalf of organizations other than ISI in connection with
14 these transactions. No documentation supports the notion that any purchaser believed that ISI had
15 any role in these transactions which, indeed, it did not. Except as so admitted, ISI denies the
16 allegations in paragraph 9 because they fail to fully and accurately describe the pay telephones sold
17 through FBG by Brown.

18 10. ISI denies the allegations in paragraph 10 because they fail to fully and accurately
19 describe the agreements and options for operating and maintaining the pay telephones sold by
20 Brown.

21 11. ISI was not involved in the offer or sale of the pay telephones, therefore it is
22 without sufficient information or knowledge to form a belief as to the truth or falsity of the
23 allegations in paragraph 11. Accordingly, the allegations in paragraph 11 are denied in their
24 entirety.

25 12. ISI was not involved in the offer or sale of the pay telephones, therefore it is
26 without sufficient information or knowledge to form a belief as to the truth or falsity of the
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1 allegations in paragraph 12. Accordingly, the allegations in paragraph 12 are denied in their
2 entirety.

3 13. ISI was not involved in the offer or sale of the pay telephones, therefore it is
4 without sufficient information or knowledge to form a belief as to the truth or falsity of the
5 allegations in paragraph 13. Accordingly, the allegations in paragraph 13 are denied in their
6 entirety.

7 14. ISI is without sufficient information or knowledge to form a belief as to the truth or
8 falsity of the allegations in paragraph 14. Therefore, the allegations in paragraph 14 are denied in
9 their entirety.

10 15. ISI acknowledges that the Securities and Exchange Commission ("SEC") brought
11 an action against Alpha in the United States District Court, District of Oregon. A decision was
12 issued in this matter on February 7, 2002, SEC v. Alpha Telcom, Inc., 187 F. Supp.2d 1250 (D.
13 Ore. 2002). ISI is without sufficient information or knowledge to form a belief as to the truth or
14 falsity of the remaining allegations in paragraph 15 and therefore these allegations are denied in
15 their entirety.

16 16. ISI admits that on or about November 1, 1996, in an Annual Regulatory
17 Questionnaire, Brown responded to the question "[d]o you participate in any multi-level marketing
18 programs?" as follows: "Signed up for TSI phone card – haven't pursued any marketing
19 whatsoever." ISI further states that the TSI phone cards were unrelated to the pay telephones at
20 issue in the Notice and were never pursued by Brown. Moreover, the allegations in this paragraph
21 are an incomplete recital of the responses contained in the Annual Regulatory Questionnaire.
22 Except as so admitted, ISI denies the allegations in paragraph 16 in their entirety.

23 17. ISI is without sufficient information or knowledge to form a belief as to the truth or
24 falsity of the allegations in paragraph 17. Therefore, the allegations in paragraph 17 are denied in
25 their entirety.

1 18. ISI is without sufficient information or knowledge to form a belief as to the truth or
2 falsity of the allegations in paragraph 18. Therefore, the allegations in paragraph 18 are denied in
3 their entirety.

4 19. ISI admits that on or about April 19, 1999, Brown requested that ISI approve the
5 sale of pay telephones as an outside business activity. Brown sent materials relating to these
6 products to ISI Compliance for review, including marketing and offering documents relating to
7 ETS and Phoenix.

8 20. ISI denies each and every allegation in paragraph 20 because they inaccurately
9 describe conversations between Tidwell and Brown.

10 21. ISI denies each and every allegation in paragraph 21.

11 22. ISI admits the allegations in paragraph 22.

12 23. ISI is without sufficient information or knowledge to form a belief as to the truth or
13 falsity of the allegations in paragraph 23. Therefore, the allegations in paragraph 23 are denied in
14 their entirety.

15 24. ISI is without sufficient information or knowledge to form a belief as to the truth or
16 falsity of the allegations in paragraph 24. Therefore, the allegations in paragraph 24 are denied in
17 their entirety.

18 25. ISI is without sufficient information or knowledge to form a belief as to the truth or
19 falsity of the allegations in paragraph 25. Therefore, the allegations in paragraph 25 are denied in
20 their entirety.

21 26. ISI is without sufficient information or knowledge to form a belief as to the truth or
22 falsity of the allegations in paragraph 26. Therefore, the allegations in paragraph 26 are denied in
23 their entirety.

24 27. ISI admits the allegations in paragraph 27.

25 28. ISI is without sufficient information or knowledge to form a belief as to the truth or
26 falsity of the allegations in paragraph 28. Therefore, the allegations in paragraph 28 are denied in
27 their entirety.

1 29. ISI is without sufficient information or knowledge to form a belief as to the truth or
2 falsity of the allegations in paragraph 29. Therefore, the allegations in paragraph 29 are denied in
3 their entirety.

4 30. ISI admits that, on April 24, 2000 in an Annual Regulatory Questionnaire for the
5 calendar year 1999, Brown identified "Alpha Telcom (ATC)" as an independent activity through
6 which he received remuneration other than insurance commissions. Except as so admitted, ISI
7 denies each and every allegation in paragraph 30.

8 31. ISI admits that, on July 14, 2000 in an office audit, Brown reported that his outside
9 business activity involving phone sales comprised 50% of his business and that he had year to date
10 sales of payphones of \$200,000.

11 32. ISI is without sufficient information or knowledge to form a belief as to the truth or
12 falsity of the allegations in paragraph 32. Therefore, the allegations in paragraph 32 are denied in
13 their entirety.

14 33. ISI admits that on August 18, 2000, Scott Lenhart, Assistant Vice President of ISI's
15 Compliance Department, confirmed and reiterated recent conversations between Brown and the
16 Compliance Department that Brown may not "participate in any way in the sale of any telephone
17 leasing or pay telephone arrangements for any company."

18 34. ISI is without sufficient information or knowledge to form a belief as to the truth or
19 falsity of the allegations in paragraph 34. Therefore, the allegations in paragraph 34 are denied in
20 their entirety.

21 35. ISI denies each and every allegation in paragraph 35.

22 36. ISI denies each and every allegation in paragraph 36.

23 37. ISI denies each and every allegation in paragraph 37.

24 38. ISI was not involved in the offer or sale of the pay telephones, therefore it is
25 without sufficient information or knowledge to form a belief as to the truth or falsity of the
26 allegations in paragraph 38. Accordingly, the allegations in paragraph 38 are denied in their
27 entirety.

39. ISI was not involved in the offer or sale of the pay telephones, therefore it is without sufficient information or knowledge to form a belief as to the truth or falsity of the allegations in paragraph 39. Accordingly, the allegations in paragraph 39 are denied in their entirety.

IV.

VIOLETION OF A.R.S. § 44-1841

(Offer or Sale of Unregistered Securities)

40. ISI denies each and every allegation in paragraph 40.

41. ISI denies that the pay telephones were required to be registered pursuant to the provisions of Articles 6 or 7 of the Securities Act. Therefore, ISI denies each and every allegation in paragraph 41.

42. ISI denies each and every allegation in paragraph 42.

V.

VIOLATION OF A.R.S. § 44-1191

(Fraud in Connection with the Offer or Sale of Securities)

43. ISI denies each and every allegation in paragraph 43. ISI did not participate in any way in the offer or sales of the pay telephones. As such, ISI did not make any misrepresentations or fail to disclose any information to any payphone purchasers. Mr. Brown did not act on behalf of ISI and none of his customers thought otherwise. As for the documents referenced in this paragraph, ISI is without sufficient information or knowledge to form a belief as to the truth or falsity of the allegations relating to these documents and therefore these allegations are denied in their entirety.

44. ISI denies each and every allegation in paragraph 44.

45. ISI denies each and every allegation in paragraph 45.

46. ISI denies each and every allegation in paragraph 46.

1 VI.

2 REMEDIES PURSUANT TO A.R.S. § 44-1961

3 (Denial, Revocation or Suspension of Dealer Registration)

4 47. ISI denies each and every allegation in paragraph 47.

5 VII.

6 REMEDIES PURSUANT TO A.R.S. § 44-1962

7 (Denial, Revocation or Suspension of Registration of Salesman)

8 48. ISI denies each and every allegation in paragraph 48.

9 VIII.

10 REQUESTED RELIEF

11 With regard to the Division's Requested Relief, ISI asks the Commission to deny the
12 request for a Cease and Desist Order and dismiss this proceeding, deny the request that ISI take
13 affirmative action to correct the conditions resulting from its or Brown's acts, and deny the request
14 for administrative penalties because ISI did not commit any violations of the Arizona Securities
15 Act, did not control Brown and exercised reasonable supervision over Brown. The Division's
16 Request for Restitution is inappropriate not only for these reasons but also because ISI did not
17 participate in the sales of these pay telephones. Brown did not act on behalf of ISI. He never
18 represented to the purchasers that he was acting for ISI and the purchasers had no reason to believe
19 otherwise. ISI did not receive any remuneration from Brown's sales of these pay telephones.

20 IX.

21 HEARING OPPORTUNITY

22 ISI has requested a hearing pursuant to A.R.S. § 44-1972.

23 X.

24 JURY TRIAL

25 ISI requests a trial by jury on all issues raised in the Notice.
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First Affirmative Defense

No violation of the Arizona Securities Act occurred because the pay telephones at issue are not securities. Beginning in 1997 United States courts of appeal began holding that telephone programs were not securities. The Sixth and Eleventh Circuit Courts of Appeals have held that pay telephone programs as offered by ETS Payphones, Inc. were not securities. *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281 (11th Cir. 2002); *Cooper v. King*, 114 F.3d 1186, 1997 WL 243424 (6th Cir. May 9, 1997); *see also In the matter of Francis A Rahaim and Rahaim Financial Services*, Memorandum of Decision and Order, Case No. E-2000-22, Securities Division (Mass. July 11, 2000) (finding that the ETS program was not an investment contract).

Second Affirmative Defense

Third Affirmative Defense

The Division alleges that ISI is primarily liable for violations of A.R.S. §§ 44-1841 and 44-1991, the registration and anti-fraud provisions of Arizona's Securities Act. ISI, however, did not make, participate in or induce the sales of the telephone programs as required by A.R.S. § 44-2003 and cannot be primarily liable.

1 The Arizona Court of Appeals has set forth the standard necessary to establish liability for
2 “participating” or “inducing” the sale of securities for purposes of A.R.S. § 44-2003. *Standard*
3 *Chartered*, 190 Ariz. at 17-23, 945 P.2d at 328-34.² The court held that a party must “partake” in
4 the sale of securities in order to “participate” in the transaction. *Id.* at 21, 945 P.2d at 332. To
5 induce the sale of securities, a party must purposefully or intentionally cause the sale. *Id.* at 21-22,
6 945 P.2d at 332-33. Likewise, a party must “persuade” or “prevail” upon another individual to
7 buy a security in order to “induce” the sale of securities. *Id.* at 21-22, 945 P.2d at 332-33.

8 The court further held that to make, participate in or induce the sale of a security: 1) a
9 party must have more than a collateral role in the sale; and 2) any alleged misstatements made by
10 the party must go beyond “merely [having] the effect of influencing a buyer” to purchase the
11 security. *Id.* at 22, 945 P.2d at 333. The court held that by use of the word “induce” the legislature
12 did not intend to stretch liability under the Act to “collateral actors . . . remote from the transaction,
13 who neither financially participate, nor promote or solicit the transaction . . .” *Id.*

14 ISI did not sell the telephone programs or participate in the relevant transactions.
15 Likewise, there is no evidence that ISI induced the sales by financially participating in, promoting
16 or soliciting any of these transactions. *Standard Chartered*, 190 Ariz. at 21-22, 945 P.2d at 332-
17 33. The uncontroverted evidence is to the contrary. ISI had no involvement with the sales of the
18 telephone programs and received no benefit from the sales. Brown did not act on behalf of ISI and
19 none of his customers thought otherwise. Accordingly, ISI cannot have primarily violated A.R.S.
20 §§ 44-1841 and 44-1991. The Commission should dismiss all claims that ISI is primarily liable for
21 the sales of the pay telephones.

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24 ² The *Standard Chartered* decision construed the terms “participated in” and “induced” under the
25 former version of A.R.S. § 44-2003, which applied only to actions brought under A.R.S. §§ 44-2001 and
26 44-2002. A.R.S. § 44-2003, however, has been amended, and now also applies to actions brought under
27 A.R.S. § 44-2032. The amended version of A.R.S. § 44-2003 includes the “participated in” and “induced”
 language that was in the earlier version of the statute. Also, the court in *Standard Chartered* declined to
 apply caselaw construing the federal securities statutes. 190 Ariz. at 18, 945 P.2d at 329. Accordingly, the
 Commission must defer to the court’s interpretation of A.R.S. § 44-2003.

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Fourth Affirmative Defense

The Division alleges that, pursuant to A.R.S. § 44-1999, ISI directly or indirectly controlled Brown and therefore is liable to the same extent as Brown for his alleged violation of section 44-1991. Section 44-1999 mirrors section 20(a) of the Securities Exchange Act of 1934 ("Exchange Act"). 15 U.S.C. § 78t(a). There are no Arizona cases interpreting A.R.S. § 44-1999. Arizona courts, however, look to federal court decisions when interpreting provisions of the Arizona Securities Act that are identical or similar to federal securities statutes. *Vairo v. Clayden*, 734 P.2d 110 (Ariz. App. 1987).

To establish control person liability, the Division must prove that a primary violation was committed and that ISI directly or indirectly controlled the violator. *Paracor Finance v. General Electric Capital Co.*, 79 F.3d 878, 888-89 (9th Cir. 1996). Specifically, the Division must present evidence that: (1) ISI actually exercised control over a person or company that violated the securities laws; and (2) ISI possessed the power to control the activity upon which the primary violation was predicated. *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir.), *cert. denied*, 474 U.S. 1057 (1986); *see also Brown v. Enstar Group, Inc.*, 84 F.3d 393, 396 (11th Cir. 1996), *cert. denied*, 117 S. Ct. 950 (1997).

Here, Brown conducted the pay telephone sales as an outside business activity through his independent insurance agency. ISI did not exercise any control over this activity nor did ISI possess the power to control this activity.

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Fifth Affirmative Defense

Imposing vicarious liability on ISI as a control person would be improper because Brown's allegedly wrongful conduct did not involve transactions that are "normally supervised" by the broker-dealer. *Hauser v. Farrell*, 14 F.3d 1338, 1342 (9th Cir. 1994). As acknowledged by the

1 court in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575, n.26 (9th Cir. 1990), broker-
2 dealers may avoid control person liability by showing that:

3 When [the claimants] entrusted their money to [the registered
4 representative,] they were not reasonably relying upon him as a
5 registered representative of [the broker-dealer], but instead were
6 placing the money with [the representative] *for purposes other
than investment in markets to which [the representative] had
access only by reason of his relationship with his] broker-dealer.*

7 (emphasis added); accord *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 880-81 (7th Cir.
8 1992).

9 Registered representatives who associate with broker-dealers as independent contractors
10 sometimes operate additional small enterprises unrelated to the securities offered by the broker-
11 dealer through its other registered agents. Investors who entrust their money to such persons may
12 not, in making their investments, rely on an agent's status as a registered representative of the
13 broker-dealer. In such circumstances, the investors are placing their money with a registered
14 representative for purposes other than investment in markets to which the representative has access
15 solely by reason of his relationship with the broker-dealer. Under principles like those articulated
16 in *Hauser* and *Hollinger*, where the representative has not used its broker-dealer's access to the
17 securities markets to perpetrate fraud, no control person liability may attach. *Hauser*, 14 F.3d at
18 1342; *Hollinger*, 914 F.2d at 1575, n. 26. Such is the situation here. The purchasers of the pay
19 telephones had no reasonable basis to believe that ISI was involved in any way with their
20 purchases. ISI does not nor has it ever sold pay telephones. These products were completely
21 unrelated to any securities offered or sold by ISI. These individuals purchased their payphones
22 through Brown and his insurance agency. Brown did not use ISI's access to the securities markets
23 to effectuate these sales. He did not represent that these payphones were products of ISI or sold
24 through ISI. None of the documentation referenced ISI. The purchasers made their checks
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1 payable to entities other than ISI and received no documents from ISI referencing these products.
2 In fact, the vast majority of the purchasers are complete strangers to ISI.

3 Sixth Affirmative Defense

4 ISI is not jointly and severally liable to the same extent as Brown because it acted in good
5 faith and did not directly or indirectly induce the acts underlying the violation. Similar to A.R.S. §
6 44-1999(B), the Exchange Act makes clear that imposition of joint and several liability on “control
7 persons” for violations of federal securities laws is subject to a good faith defense. 15 U.S.C.
8 § 78t(a). Under that defense, the controlling entity may avoid liability entirely by demonstrating
9 that it both “acted in good faith” and “did not directly or indirectly induce the act or acts
10 constituting the violation or cause of action.” *Id.*; *Hollinger*, 914 F.2d at 1576-78; *Arthur*
11 *Children’s Trust v. Keim*, 994 F.2d 1390, 1398 (9th Cir. 1993); *see also Rochez Bros., Inc. v.*
12 *Rhoades*, 527 F.2d 880, 891 (3rd Cir. 1975) (control person liability is subject to good faith
13 defense, which requires that the broker-dealer show that it did not culpably participate in the
14 violation at issue).

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17 Courts have noted that this good faith defense is designed to avoid holding broker-dealers
18 to a “strict liability” standard for the conduct of their representatives:

19 By recognizing [a] control relationship, we do not mean that a
20 broker-dealer is vicariously liable under § 20(a) for all actions
21 taken by its registered representatives. Nor are we making the
22 broker-dealer the “insurer” of its representatives . . . *The mere fact*
23 *that a controlling person relationship exists does not mean that*
24 *vicarious liability necessarily follows. Section 20(a) provides that*
25 *the “controlling person” can avoid liability if she acted in good*
26 *faith and did not directly or indirectly induce the violations.* By
27 making the good faith defense available to controlling persons,
Congress was able to avoid what it deemed to be an undesirable
result, namely that of insurer’s liability, and instead it made
vicarious liability under § 20(a) dependent upon the broker-
dealer’s good faith.

1 *Hollinger*, 914 F.2d at 1575 (emphasis added).

2 Courts evaluating a good faith defense to control person liability have held that the broker-
3 dealer's burden may be satisfied where the broker-dealer demonstrates that it maintained and
4 enforced a reasonable and proper system of supervision designed to prevent, as much as possible,
5 violations of federal securities law. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d
6 1111, 1120 (5th Cir. 1980); *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1134-35 (9th Cir. 1975). As
7 long as internal control procedures were both in place and diligently executed, broker-dealers will
8 not be held to "insurer's liability" for every wrongful act taken by registered representatives.
9 *Hollinger*, 914 F. 2d at 1575; *Rochez Bros.*, 527 F.2d at 891; *see also Hauser*, 14 F.3d at 1341-43
10 (broker-dealer was not liable for investments in a small enterprise that was unrelated to any of the
11 securities offered by the broker-dealer through its registered agents).

13 ISI maintained and enforced a reasonable and proper system of supervision. Moreover,
14 ISI's conduct in this instance satisfies both prongs of the good faith defense. ISI acted in good
15 faith in approving Brown's involvement in the sales of the pay telephones as an outside business
16 activity. ISI was not involved in the offers or sales of these pay telephones and did not directly or
17 indirectly induce any acts in connection with these sales.

19 **Seventh Affirmative Defense**

20 ISI exercised appropriate supervision over Brown. NASD Rule 3010 sets forth the
21 standard for supervision applicable in the industry. Rule 3010 provides:

- 22 (a) Each member shall establish and maintain a system to
23 supervise the activities of each registered representative
24 and associated person that is **reasonably designed** to
25 achieve compliance with applicable securities laws and
26 regulations, and with the Rules of [the NASD] . . .
27 (b) Each member shall establish, maintain and enforce written
procedures to supervise the types of business in which it

engages and to supervise the activities of registered representatives and associated persons that are **reasonably designed** to achieve compliance with applicable securities laws and regulations, and with the Rules of [the NASD] . . .

NASD Rule 3010 (2001) (emphasis added); *see also In the Matter of Dean Witter Reynolds, Inc., et al.*, 2001 WL 47244, SEC Admin. Pro. File No. 3-9686 (Jan. 22, 2001). Throughout Rule 3010, the articulated standard is ***reasonableness***. *See, e.g.* NASD Conduct Rule 3010(a)(6) (reasonable efforts to determine that supervisory personnel are qualified); (a)(8) (reasonably designed inspections); (b)(1) (reasonably designed written procedures); (b)(4) (revision of written procedures within a reasonable time); (c) (reasonably designed internal inspections); (d)(1),(2) (reasonably designed procedures for review of transactions and correspondence).

Like the NASD, the Securities Division's rules emphasize that a broker-dealer's supervision must be ***reasonable***. A.A.C. R14-4-131 provides that no person shall be deemed to have failed to reasonably supervise any other person if:

1. There have been established and maintained written procedures, and a system for applying such procedures, which would **reasonably** be expected to prevent or detect, insofar as practicable, any such violation by such other person of the Arizona Securities Act, or of any rule or regulation adopted thereunder; and
2. Such person has **reasonably** discharged the duties and obligations incumbent upon that person by reason of such procedures and system without **reasonable** cause to believe that such procedures and system were not being complied with.

The relevant inquiry under both the NASD Rules and Arizona's statutes and rules is what was reasonable given the particular facts and circumstances at the time. Inherent in these standards is the principle that supervision does not have to be fail-proof. Simply because a violation occurs does not mean that the supervision was de facto inadequate. *NASD Provides Guidance on Supervisory Responsibilities*, NASD Notice to Members 99-45 (June 1999) (Rule

1 3010 "requires that a member's supervisory system be reasonably designed to achieve compliance
2 with applicable laws and regulations. **This standard recognizes that a supervisory system**
3 **cannot guarantee firm-wide compliance with all laws and regulations** (emphasis added).
4 Further, supervision "cannot be judged in hindsight or with information learned long after the
5 events in question occurred." *In the matter of Dean Witter Reynolds Inc.*, 2001 WL 47244 at *49;
6 *see also In the matter of Quest Capital Strategies, Inc., et al.*, 1999 WL 202487, S.E.C. Admin.
7 Pro. File No. 3-8966 (April 12, 1999) ("the Commission's 'decisions have been careful not to
8 substitute the knowledge, gleaned with hindsight, of actual wrongdoing by someone under a
9 supervisor's control for an assessment of whether the supervisor's conduct was appropriate under
10 the circumstances").

12 ISI had in place a system of supervision reasonably designed to achieve compliance with
13 the applicable securities laws. As part of its compliance system, ISI made Brown aware of his
14 obligation to inform the firm before engaging in any outside business activity. Pursuant to this
15 obligation, Brown sought approval from ISI before engaging in the sales of the pay telephones.
16 Brown submitted materials regarding these products to the Assistant Vice President of ISI's
17 Compliance Department, Rod Tidwell. Tidwell, armed with his over 40 years of experience in the
18 industry, inquired of Brown regarding these products. He also directed Brown to contact the
19 Division to ensure that it did not consider these pay telephones to be securities. Brown spoke with
20 the Division and conveyed to Tidwell that the Division did not consider these payphones to be
21 securities. In light of all of this information, Tidwell made the reasonable determination that these
22 products were not securities. He approved Brown's sale of these products as an outside business
23 activity. Regardless of whether Tidwell's determination was correct, his review and approval of
24 this outside business activity was reasonable.
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1 Once ISI made the determination that these products were not securities, NASD Rule 3030
2 governed its supervisory obligations. According to various NASD Notices to Members, NASD
3 Rule 3030 was promulgated so that "member firms receive prior notification of all outside
4 business activities of their associated person so that the member's objections, if any, to such
5 activities may be raised at a meaningful time and so that appropriate supervision may be exercised
6 as necessary under applicable law."³ NASD Notice to Members 88-5 (Feb. 14, 1988). Outside
7 business activities by definition do not involve the brokerage firm. ISI had no obligation to
8 supervise Brown's fixed insurance business or any other business of its associated persons that
9 does not involve ISI's business or its products. Thus, once an activity is approved under Rule
10 3030 member firms do not have further supervisory obligations with respect to that activity.
11 Accordingly, the conduct of InterSecurities and its compliance employees in this circumstance was
12 totally appropriate and consistent with industry standards.
13

14 **Eighth Affirmative Defense**

15 The Division is estopped from asserting any claims against ISI. Tidwell directed Brown to
16 contact the Division to determine if the Division considered the payphones to be securities and/or
17 had any problems with the payphone companies and their activities. Brown spoke with an attorney
18 at the Division, upon information and belief, named Wendy Coy. Regarding this conversation
19 Brown testified as follows:
20

21 April 27th of 1999, I spoke to Wendy on the telephone. I asked
22 her if she knew anything about ETS and Phoenix Telecom. She, I
23 said, I asked her if there had been any problems or complaints, if
24 she knew anything about this program, if there was any problems
25 with it being a security. She first of all said she didn't know of any
problems with the companies. She did tell me this. She says, "I've
just completed prosecuting two pay phone companies, Pinnacle

26 ³ After receiving comments on the proposed Rule, the NASD determined that prompt notice, rather
27 than prior notice was adequate to achieve the goals of the Rule. See Notice to Members 88-45 (Aug. 1,
1988).

1 Pay Phones and Paramount Pay Phones, that were structured as
2 limited partnerships." And she says, "Is it structured as a limited
3 partnership?" No, it is not. It is actually filed as a business
4 opportunity, the client owns the asset, and it's not a limited
5 partnership. She said, "Well then, I don't have a problem." It's
6 basically, you know, she said as long as it is not a limited
7 partnership is what basically she really emphasized, and that was
8 the discussion I had with her.

9 Testimony of Brown, 54:20-25 to 55:1-16. Brown conveyed this information to ISI Compliance.

10 Upon information and belief, Ms. Coy was and is an attorney in the enforcement section of
11 the Division. She has been with the Division since 1990, and thus, was very experienced in
12 securities matters when she spoke with Brown. Upon information and belief, on the day that Ms.
13 Coy spoke with Brown she was designated as the individual with authority to respond on behalf of
14 the Division to inquiries from the general public. At no time did Ms. Coy tell Brown that he could
15 not rely on her representations. Had the Division advised Brown of any possibility of problems
16 with these companies, Brown would not have sold the pay telephones and ISI would not have
17 approved this activity as an outside business activity. Accordingly, the Division is estopped from
18 asserting these claims.

19 In sum, the Division represented to Brown that the pay telephones were not securities. ISI,
20 in reliance on this representation, approved Brown's sales of these pay telephones as an outside
21 business activity. ISI has been injured by the Division's repudiation of this prior position. The
22 Division's apparant change of opinion will create a serious injustice against ISI. Moreover, the
23 public interest would be well-served by requiring the Division to deal responsibly with individuals
24 and regulated entities.

25 Ninth Affirmative Defense

26 ISI did not participate in the sales of these pay telephones. Brown did not act on behalf of
27 ISI. He never represented that he was acting for ISI and the purchasers believed he was acting on

1 behalf of totally separate entities. Thus, there is no basis for the purchasers to assert that they
2 reasonably relied on ISI in determining to make their purchases. The purchasers bought their pay
3 telephones through Brown and his independent insurance agency. Of the 49 individuals to whom
4 Brown sold pay telephones, only nine of these individuals ever did any business with ISI and only
5 eight had accounts with ISI. The other 40 individuals were not customers and believed correctly
6 that Brown was acting on behalf of Financial Benefits Group, Inc. and sales organizations
7 associated with the telephone companies. Accordingly, the Commission should deny the
8 Division's request for restitution and/or any other "appropriate affirmative action."
9

10 **Tenth Affirmative Defense**

11 The Notice fails to state a claim upon which relief can be granted.

12 **Eleventh Affirmative Defense**

13 The Division has failed to plead fraud with reasonable particularity as required by Rule
14 9(b) of the Arizona Rules of Civil Procedure.

15 **Twelfth Affirmative Defense**

16 The purchasers of the pay telephones did not rely, reasonably or otherwise, on any alleged
17 misrepresentation or omission of ISI.
18

19 **Thirteenth Affirmative Defense**

20 ISI did not know and in the exercise of reasonable care could not have known of any
21 alleged untrue statements or material omissions as set forth in the Notice.
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23 **Fourteenth Affirmative Defense**

24 ISI did not act with the requisite scienter.
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Twenty-second Affirmative Defense

This proceeding before the Arizona Corporation Commission denies ISI essential due process and is lacking in fundamental fairness. ISI's constitutional rights are further denied if it is not afforded trial by jury of this matter.

Twenty-third Affirmative Defense

The Division cannot meet the applicable standards for any of the relief they are seeking in the Notice.

Twenty-fourth Affirmative Defense

There is no likelihood of future violations. Despite the representations of the Division that the pay telephones were not securities and that the Division had no problems with these pay telephones, ISI on its own accord instructed Brown to stop engaging in sales of the pay telephones.

Twenty-fifth Affirmative Defense

ISI alleges such other affirmative defenses set forth in the Arizona Rules of Civil Procedure 8(c) as may be determined to be applicable during discovery.

1 RESPECTFULLY SUBMITTED this 23rd day of June, 2003.

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6 AND

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15 ORIGINAL and thirteen copies of the foregoing
16 hand-delivered this 23rd day of June, 2003 to:

17 Docket Control
18 Arizona Corporation Commission
19 1200 West Washington Street
20 Phoenix, AZ 85007

21 COPY of the foregoing hand-delivered
22 this 23rd day of June, 2003 to:


23 Mark Sendrow
24 Director of Securities
25 Securities Division
26 Arizona Corporation Commission
27 1300 W. Washington Street
Phoenix, AZ 85007

Philip J. Dion III
Administrative Law Judge
Arizona Corporation Commission
1200 W. Washington Street
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14 
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